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Local governments are facing significant financial challenges

In the last few years, local governments have faced a daunting economic environment. A small but growing number of Washington's local governments are showing signs of declining financial condition that may affect their ability to serve residents and taxpayers.

As shown in the chart to the right, since 2007, the State Auditor’s Office has identified more indicators of declining condition in a growing number of governments. Common financial issues include difficulty in paying bills, dwindling or negative fund balances and rising debt.

Greater awareness of the challenges facing local governments may help communities identify and resolve issues. When residents, taxpayers, and government leaders understand financial concerns, they can take steps to return to sound financial condition.

State Auditor’s responsibility to audit local governments

The State Auditor’s Office plays an important role in monitoring local government financial condition. Knowing what we look for and what we have reported can help governments of all types identify potential issues before they rise to the level of declining financial condition.

State law directs the Office to audit each government’s financial conditions at least once every three years. The law (RCW 43.09.260) says, “On every such examination, inquiry shall be made as to the financial condition and resources of the local government...”

Washington has more than 2,150 local governments, including cities and counties, school districts, ports, fire districts, public facilities districts, and many others.

When assessing financial condition, the Auditor’s Office looks for sound financial management practices and considers multiple issues. In general, sound financial condition exists when a local government:

- Is able to balance its budget without resorting to excessive external borrowing.
- Collects revenue from dependable and predictable sources.
- Can continue to provide adequate services even through periods of economic stress and community changes.
Financial stress mounting on local governments

The Washington Economic and Revenue Forecast Council called the recent recession the worst and deepest of its kind since World War II. During and after the recession, local governments in the state experienced lower revenues when in many cases, demand for services grew.

Major sources of local government revenue declined, such as property tax revenues, sales tax revenues, and revenues from timber and property sales. In addition, citizen initiatives have lowered local government revenue or set limits on property tax rates.

Many of the issues we have reported on reflect the challenging economic conditions. For example, most of these governments’ audits reported declining or negative fund balances, expenditures exceeding revenues and the need to improve financial management and oversight. More recently, the number of governments increasing their debt has risen.

How we review financial condition

The State Auditor’s Office takes a comprehensive approach to reviewing the financial condition of local governments and reports the result of those audits, including governments’ responses, when those issues are included in our reports. The frequency of our audits depends on the size and complexity of the government, history of audit issues and citizen concerns.

In 2006 to 2011, the Washington State Auditor’s Office has found common indicators of financial decline in local governments as shown in the graph above. A detailed description of each indicator is on the next page.
What are the indicators of declining financial condition?

- **Declining or Negative General Fund Balance:** A situation in which the General Fund has declined significantly over time or has a negative balance. The General Fund pays for services such as public safety, community planning, public health, etc. The ending balance identifies the amount of resources the government has available for these services.

- **Expenditures Exceeding Revenues:** Operating expenditures exceed revenues in the General Fund.

- **Lack of Adequate Management Action or Oversight:** Indications that elected officials are not aware of, engaged, or taking necessary actions to stabilize the financial condition, such as reducing expenditures through program or staff reductions or identifying new revenue sources.

- **Reliance on Interfund Loans:** When the General Fund does not have sufficient funds to cover general government operating expenses, the government loans money from a separate fund.

- **Reliance on Registered Warrants:** Borrowing money from the County to pay for operations and to address cash-flow shortages. This is known as “registered warrants” and interest is charged on these funds, resulting in an additional expense to the local government.

- **Increasing or High Debt:** The use of other sources of long-term financing, such as issuing Bond Anticipation Notes or taking out bank loans, to cover general operating expenditures.

- **Reliance on Unsupported Cost Allocations:** The costs of central services such as administration, human resources, payroll and purchasing can be allocated among government funds that benefit from the services. The government must adopt a fair and equitable method of distributing these shared costs among the funds. At times, these allocations are not properly supported, such as allocating more costs to funds with the most resources.

- **Contingent Debt Liability:** Local governments can accept responsibility for loans through contracts or agreements. These liabilities are contingent on certain events or circumstances occurring or not occurring.

- **Failed Levy:** Some local governments receive funding from voter-approved property taxes called levies. Typically, the levies fund maintenance and operations and apply for a year or two. Levy failures can have a major impact on financial condition.

- **Pending Litigation:** Litigation costs or pending legal judgments that risk depleting available fund reserves.
How widespread are these issues?

The number of local governments in financial distress is small, but growing. Statewide, our audits have reported indicators of declining financial condition in 88 governments since 2006. The table below shows that certain types of governments show a higher percentage of economic distress.

### Number of governments with declining financial condition by type

<table>
<thead>
<tr>
<th>Type of government</th>
<th>Total number of entities</th>
<th>Number with declining financial condition</th>
<th>Percent with declining financial condition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hospital districts</td>
<td>58</td>
<td>13</td>
<td>22%</td>
</tr>
<tr>
<td>Risk pools</td>
<td>18</td>
<td>3</td>
<td>17%</td>
</tr>
<tr>
<td>Public development authorities/public facilities districts</td>
<td>64</td>
<td>7</td>
<td>11%</td>
</tr>
<tr>
<td>Cities</td>
<td>281</td>
<td>28</td>
<td>10%</td>
</tr>
<tr>
<td>Housing authorities</td>
<td>43</td>
<td>4</td>
<td>9%</td>
</tr>
<tr>
<td>School districts</td>
<td>295</td>
<td>16</td>
<td>5%</td>
</tr>
<tr>
<td>Counties</td>
<td>39</td>
<td>2</td>
<td>5%</td>
</tr>
<tr>
<td>Water/sewer districts</td>
<td>190</td>
<td>4</td>
<td>2%</td>
</tr>
<tr>
<td>Fire districts</td>
<td>379</td>
<td>5</td>
<td>1%</td>
</tr>
<tr>
<td>Other</td>
<td>823</td>
<td>6</td>
<td>1%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>2,190</strong></td>
<td><strong>88</strong></td>
<td><strong>4%</strong></td>
</tr>
</tbody>
</table>

What changes have occurred in the types of governments with declining financial condition?

We are seeing the sharpest increase in cities and counties. In 2007, six cities experienced indicators of declining financial condition. In 2010, 15 cities had those indicators. Counties did not experience these indicators until 2009.

Over the same period, we have seen the number of school districts with indicators decline from 12 between 2006-2008 to seven between 2009-2011.

State law does not authorize the state to step in when a local government is facing fiscal crisis with one exception – school districts. The law authorizes the Superintendent of Public Instruction to intervene through protocols contained in Chapter 392-123-060 through 105 of the Washington Administrative code. The 2012 Legislature also adopted a law to specifically address school district financial insolvency.

Where are these local governments?

Some counties and regions of the state have higher numbers of governments facing declining financial condition, as shown in the map on the next page. Local governments in several counties in Southwest Washington have had more indicators than those in other counties. We have reported about declining financial condition on 11 local governments in Grays Harbor County and 12 in Lewis County.

We have not found indicators of distress in local governments in a number of counties including Adams, Asotin, Clallam, Clark, Douglas, Ferry, Kittitas, Klickitat, Spokane, and Wahkiakum.
Patterns by type of local government

Different forms of governments tend to have different kinds of indicators. The table below lists the top three indicators of declining financial condition for three specific types of governments. Declining/negative fund balance is the most common condition for cities and school districts. Declining fund balance is the fourth most common condition for hospitals, which more often has expenditures exceeding revenues.

Top three indicators of financial distress by type of government

<table>
<thead>
<tr>
<th>Cities</th>
<th>Hospital districts</th>
<th>School districts</th>
<th>All others</th>
</tr>
</thead>
</table>

Number of local governments with declining financial conditions by county

Tough conditions have led 88 governments to show financial distress since 2006.

Source: State Auditor's Office as of October 2012.

Note: The circles show how many governments with an indicator of declining financial condition since 2006 are located in each county. Eighty-eight governments, including 28 cities, two counties, 16 school districts, and 42 other government districts, have had indicators of declining financial condition since 2006.
How can a government assess its financial condition?

Local governments may wish to examine several areas as they manage their financial operations and evaluate early warning signs. These questions are based on the primary areas the State Auditor’s Office considers when conducting audits.

Operating Margin: Are governmental activities sustainable?
- Do revenues exceed the expenditures for total government funds?
- Is there revenue in excess of expenditures to contribute towards capital outlays, transfers, increases in fund balances and/or other uses?
- Is cash flow remaining positive throughout the year, as well as at the end of the year?
- Are costs being reduced or programs/services being cut to resolve the financial difficulties?
- Are budget amendments being approved before making expenditures?
- Are central services being allocated by a fair and equitable method?

Change in Fund Balance: Did the financial condition of the general fund improve, decline or remain steady?
- Are the fund balances within reasonable levels?
- How many days will the government be able to cover operations with its fund balance?
- If fund balances are declining or negative, is there a formal action plan to reverse the trend?

Fund Balance Sufficiency: Is the fund balance enough to cover operating expenditures?
- Are there any anticipated changes in funding levels (i.e. due to changing regulation, grant programs or levies) or new/increased costs (i.e. changing regulation or union negotiations)?
- What is the government’s ability to deal with emergencies and unanticipated needs?
- What is the exposure to casualty and legal risks?

Debt Load: Is the debt load sustainable?
- Is there borrowing in order to cover operating expenses (i.e. use of registered warrants and interfund loans)?
- If the government has entered into contingent loan agreements, what is the potential impact?
- How much of the government’s revenue is going toward debt payments?
- Is current debt being repaid, including loans and bonds?
- Are loans being made from one fund to another to cover expenses?
- If so, are the inter-fund loans being repaid on time and with interest?
- Is there capacity to make large debt payments that are due in the near future?

Financial Planning: Is management aware of and taking action to address financial difficulties?
- Is there a formal plan developed and followed to address these issues?
- Is there a long term financial plan that looks out beyond the current budget cycle?
- If so, is the plan being followed and adjusted to correct negative financial trends?
Resources

The State Auditor’s Office Local Government Performance Center
Local government officials can use resources on this site to diagnose and improve their financial situation: [www.sao.wa.gov/PerformanceCenter](http://www.sao.wa.gov/PerformanceCenter).

Washington State Treasurer’s Office

The State Treasurer used ten financial condition indicators to assess the health of local governments. Some of these indicators are the same as those used by the Auditor’s Office. The report also includes a scoring tool to assess how widespread the financial difficulties are. If governments identify four or more stress points, the report states the entity is financially stressed.

Association of Washington Cities
Another tool for local governments is the “Red Flag Checklist: Communicating About Your City’s Financial Condition” developed by the Association of Washington Cities. It developed this tool to help cities self-assess their financial condition and to serve as a tool to communicate with city leaders, the community and businesses. This tool applies to other types of local government.

The document lists 15 financial indicators or “red flags” that indicate some level of financial concern or distress and a scoring system that can help cities or other local governments gauge their situation.


Government Finance Officers Association
The Government Finance Officers Association provides best practices and tools to help governments with financial management. The Fiscal First Aid resource provides guidance to help city officials diagnose their fiscal condition and treat the problems, as well as longer term tools and practices to help recover and remain financially healthy. The Association’s resource is available at: [http://www.gfoa.org/index.php?option=com_content&task=view&id=937&Itemid=416](http://www.gfoa.org/index.php?option=com_content&task=view&id=937&Itemid=416).

GFOA also maintains a broad list of additional best practices. Provided here are links to two primary resource pages:


State Auditor’s Office Financial Reporting System
In addition the State Auditor’s Office is working to expand the financial analysis tools in our Local Government Financial Reporting System to include financial ratios and trend information on fund balances and debt.

### Appendix A

#### Local governments with indicators of declining condition since 2009

**Airport**

**Cities and Towns**
- Eatonville (2010)
- Gold Bar (2010, 2011)
- Ilwaco (2009, 2010)
- Long Beach (2010)
- Lyman (2009)
- Mesa (2009)
- Monroe (2009)
- Montesano (2007, 2009)
- Morton (2010)
- North Bonneville (2010)
- Oakville (2007-2009)
- Ocean Shores (2009-2011)
- Pe Ell (2008, 2009)
- Port Townsend (2010, 2011)
- Sprague (2009)
- Springdale (2011)
- Sunnyside (2011)
- Tenino (2010)
- Toledo (2010)
- University Place (2010, 2011)
- Winlock (2008-2010)

**Council of Government**

**Counties**
- Grays Harbor County (2009, 2010)
- Skamania County (2011)

**Educational Service District**
- Educational Service District No. 123 (2011)

**Emergency Management Service**
- Mason County Emergency Communication Center (2010)

**Fire Districts**
- Skagit County Fire Protection District No. 3 (2010)
- Thurston County Fire Protection District No. 2 (2010)
- Thurston County Fire Protection District No. 3 (2009)
- Thurston County Fire Protection District No. 4 (2010)

**Hospital Districts**
- Garfield County Public Hospital District No. 1 (2011)
- Grant County Public Hospital District No. 2 (2007-2010)
- Grant County Public Hospital District No. 4 (2007, 2009)
- Grant County Public Hospital District No. 5 (2008, 2010)
- King County Public Hospital District No. 4 (2007, 2010)
- Okanogan County Public Hospital District No. 4 (2006, 2008, 2009)
- Okanogan-Douglas Hospital District No. 1 (2006, 2008-2010)
- Pacific County Public Hospital Care Service District No. 3 (2007, 2010, 2011)
- San Juan County Public Hospital District No. 1 (2010)

**Housing Authorities**
- Housing Authority of the City of Kalama (2010)
- Kitsap County Consolidated Housing Authority (2008-2010)
- Richland Housing Authority (2007-2009)

**Public Development Authority/ Public Facilities Districts**
- Bellingham-Whatcom Public Facilities District (2011)
- East Lewis County Public Development Authority (2007, 2011)
- Edmonds Public Facilities District (2009, 2010)
- Grays Harbor Public Facilities District (2010)
- Grays Harbor Historical Seaport Authority (2007, 2009)
- Greater Wenatchee Regional Events Center (2009, 2010)

**Risk Pools**
- Nonprofit Insurance Program (2011)

**School Districts**
- Cascade School District No. 228 (2011)
- Lake Quinault School District No. 97 (2008-2010)
- Southside School District No. 42 (2011)

**Water/Sewer Districts**
- Bear Mountain Water District (2009)
- Lewis County Water District No. 1 (2011)
- Lewis County Water District No. 2 (2007, 2011)
- Startup Water District (2009)
Local governments with indicators of declining condition, 2006-2008

Cities
   Castle Rock (2008)
   Tekoa (2007)

Conservation Districts
   Pend Oreille Conservation District (2008)
   Skagit Conservation District (2008)

Fire District

Hospital or Health Districts
   Snohomish Health District (2007)
   Jefferson County Public Hospital District No. 2 (2006)
   Grays Harbor Public Hospital District No. 1 (2007, 2008)
   Columbia County Public Hospital District No. 1 (2006-2008)

Housing Authority
   Pierce County Housing Authority (2008)

Public Development Authority
   Capitol Hill Housing Improvement Program (2008)

School Districts
   Evaline School District No. 36 (2007)
   Grand Coulee Dam School District No. 301 (2008)
   North Beach School District No. 64 (2007, 2008)
   Oak Harbor School District No. 201 (2007)
   Queets-Clearwater School District No. 20 (2006)
   San Juan Island School District No. 149 (2008)
The State Auditor’s Office Mission

The State Auditor’s Office independently serves the citizens of Washington by promoting accountability, fiscal integrity and openness in state and local government. Working with these governments and with citizens, we strive to ensure the efficient and effective use of public resources.

Americans with Disabilities

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